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Employee or Independent Contractor? Classification by The Internal Revenue Service

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EMPLOYEE OR INDEPENDENT CONTRACTOR? CLASSIFICATION BY THE INTERNAL REVENUE SERVICE

by

Martin H. Zern*

I. BACKGROUND

A frequent and contentious issue existing between businesses and the Internal Revenue Service ("IRS") is the proper classification of persons hired to perform services. If the person hired is classified as an employee, numerous obligations are imposed on the business with respect to wages it pays: federal and, if applicable, state income taxes must be withheld; social security and Medicare tax must be withheld – and matched by the business; federal and state unemployment taxes must be paid; disability and workmen's compensation insurance have to be provided; and, the employee may have to be included in whatever fringe benefit packages that are provided by the business (e.g., medical and retirement benefits). These obligations imposed in an employer-employee relationship are applicable whether the employment is full or part time (although part-time personnel may get less or no fringe benefits). On the other hand, if the relationship to the business of the person it hires is that of an independent contractor ("IC"), the only obligation of the business is to issue

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a statement (Form 1099-MISC) to the person hired setting forth the amount paid to the person, with a copy to the IRS.¹

Where the facts and circumstances create an employer-employee relationship, rather than one of an IC relationship, the person hired is considered a common-law employee. Regulations issued by the IRS list numerous factors that must be considered and evaluated in determining whether someone hired to perform services is an employee or an IC.

If a person is an employee under common-law principles, the person has the status of an employee for federal tax purposes.² As such, obligations are imposed on the employer, as previously detailed. In this regard, it may be noted an officer of a corporation is considered an employee unless the officer does not perform any services or performs only minor services and neither receives any remuneration nor is entitled to any; however, a director of a corporation in his or her capacity as such is not considered an employee.³

II. DETERMINING STATUS

A. *In General*

Under common law principles, as a broad general rule, an employer-employee relationship exists if the business for which services are performed has the right to control and direct the person performing the services not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished.⁴

Thus, an employee is someone subject to the will and control of the employer not only as to what shall be done but also as to how it shall be done. It is not necessary for the employer to actually direct and control the person as long as

the employer has the right to do so. The right to discharge is also an important factor indicating that a person is an employee. Other factors, such as the furnishing of tools and a place to work are also considerations. On the other hand, if a person is subject to the control and direction only as to the result, and not as to the means and methods of accomplishing the result, the person is an IC.⁵

Individuals such as physicians, lawyers, dentists, veterinarians, construction contractors, public stenographers, and auctioneers, engaged in business in the pursuit of and independent trade, business, or profession, in which they offer services to the public, are considered ICs.⁶

Whether an employer-employee relationship exists under common law rules in doubtful cases will be determined based upon an examination of the particular facts of each case.⁷ If the relationship exists, the designation of the relationship as something else, such as, partner, co-adventurer, agent, IC, or the like, is of no consequence.⁸ All classes or grades of personnel are included in the employer-employee relationship, including superintendents, managers and other supervisory employees, and specifically corporate officers, as previously noted.⁹

B. *Partners*

A person who is legitimately a partner in a partnership is not considered an employee.¹⁰ Whether someone is a true partner for federal tax purposes, however, depends upon the specific facts and circumstances, taking into consideration applicable state law defining a partnership relationship. The IRS, however, is not bound by a determination under state law provisions and may nevertheless conclude that an employer-

employee relationship exists despite a determination of partnership status under state law principles.

C. Relevant Factors

In determining whether an employer-employee relationship exists, the IRS for some time utilized a so-called 20-factor analysis.¹¹ However, since 1996 the IRS has changed its focus to considering all information that provides evidence of the degree of control and the degree of independence. Accordingly, the 20-factor analysis is no longer as germane. Under the new analytic regime, evidence to be considered in determining whether an employer-employee relationship exists falls into three categories: behavioral control, financial control, and the type of relationship of the parties.¹²

1. Behavioral Control:

Factors showing that a business has the right to control how a worker does the task the worker was hired to perform include the degree of instructions that are given to the worker. Overall, the instructions to consider are about when, where and how to work. The following are examples of the type of instructions that, if present, would indicate an employer-employee relationship:

- When and where to do the work.
- What tools or equipment to use.
- What workers to hire or to assist with the work.
- Where to purchase supplies and services.
- What work must be performed by a specified individual
- What order or sequence to follow.

It is recognized that the amount of instruction can vary from job to job. The IRS realizes, however, that even if no instructions are given, there may be sufficient behavioral control if the party hiring has the right to control how the work results are achieved. For example, a business hiring a worker may not have the expertise to instruct in a highly specialized area; in some cases, no instruction may be necessary. The key consideration is whether the business hiring has retained the right to control the details of a worker's performance, or has given up that right. An important factor is training. Employees generally are trained to perform in a certain way whereas ICs ordinarily use their own methods.¹³

2. Financial Control:

The right to control the business aspects of the worker's job is indicative of an employer-employee relationship. Factors showing financial control include:

- *Unreimbursed business expenses.* An IC is more likely to have unreimbursed business expenses than an employee, although an employee may also have such expenses. Fixed ongoing costs are also indicative of an IC.
- *Worker's investment.* Generally, an IC has a significant investment in facilities he or she uses and in tools and equipment, although it is recognized that this is not always the case.
- *Relevant market.* An IC generally offers services to the public and is free to seek out business opportunities in the relevant market. Moreover, an IC often advertises and maintains a visible business location.
- *Payment.* Employees generally are paid a regular wage based upon an hourly, weekly, or other period of time.

Such payment is indicative of employee status even though wages are supplemented with commissions. In contrast, an IC usually gets a flat fee, although some professions, notably law and accounting, commonly bill for services based upon hours worked.

- *Profit or loss.* An IC can make a profit or suffer a loss¹⁴

3. Relationship:

The relationship between parties is also a factor in determining whether an employer-employee relationship exists. The nature of the relationship between the parties may be determined by:

- A written contract describing the relationship between the parties.
- Whether a worker is provided with fringe benefits that are commonly given to employees (e.g., medical and retirement benefits).
- The permanency of the relationship. If the relationship is open ended, this generally is indicative of an employee. In contrast, an IC is hired to perform a task that is expected to be completed within a specific time period, or to complete a specific project.
- The extent that the services are a key aspect of the business. A worker that provides essential and continuous services is more likely to be subject to the direction and control of his or her activities, indicating an employer-employee relationship.¹⁵

D. Industry Examples

For further taxpayer guidance, the IRS has set forth examples by certain industry classifications.¹⁶ The examples are probably taken from those industries where misclassification is a common practice, as gleaned by IRS audits or from other sources.

1. Building and Construction Industry:

- Example 1. This example involves a person hired to supervise the remodeling of a house. The owner of the home advances no funds, buys all the necessary supplies, carries liability and worker's compensation insurance on the person hired and others hired to assist them, pays an hourly rate and constantly oversees their work. The supervisor hired may not transfer the assistants to other jobs and may not work on other jobs until the current job is completed. He assumes no responsibility to complete the work and has no contractual liability if he doesn't. Conclusion: The person hired and his assistants are employees.
- Example 2. This example involves an experienced tile setter hired orally by a corporation to render services at various job sites. He uses his own tools and performs services in the order designated by the corporation and according to its specifications. The corporation provides all the materials and makes frequent inspections of his work and pays him on a piecemeal basis. The corporation also provides worker's compensation. The worker does not have a place of business or holds himself out as available to others.

Either party can terminate the relationship at any time.
Conclusion: The tile setter is an employee.

- Example 3. In this case, an individual is hired by a corporation to provide construction labor to build a group of houses. The company agrees to pay all construction costs, but the individual supplies all tools and equipment. He personally performs services as a carpenter and mechanic getting an hourly wage. He also acts as a foreman and engages others to help him. The company has the right to hire or discharge any helper. A company executive frequently inspects the construction site. When a house is finished, the individual is paid a certain percentage of its costs. He is not responsible for defects or waste. At the end of the week, he presents the company with a statement of what he has spent, including the payroll. With the check he gets, he pays his assistants (and presumably himself), although he is not personally liable for their wages of the assistants. Conclusion: The individual and his assistants are employees.
- Example 4. In this situation, an individual is employed by a corporation to complete roofing on a housing project. Pursuant to a signed contract the individual is to get a flat amount for services rendered. The individual is a licensed roofer and carries worker's compensation and liability under his business name. He hires his own roofers and treats them as employees for federal unemployment tax purposes. If there is a problem with the roofing, the individual is responsible. Conclusion: An IC.
- Example 5. The final example involves an electrician who submitted a bid for electrical work based upon a

fixed number of hours the job is expected to take and a specified rate per hour. Thus, the amount the electrician ultimately gets is fixed by multiplying the fixed number of hours by the rate. A fixed payment is to be made every other week for 10 weeks. This is not considered payment by the hour even if more or less than the set number of hours is worked. Additionally, the electrician contracts with other companies and advertises. Conclusion: An IC.

2. *Trucking Industry:*

Here, only one example is given.

An individual operating a trucking company contracts with a corporation to deliver material at a certain amount per ton. He is not paid for any articles not delivered. He may lease other trucks and engage other drivers to complete the contract. The individual pays all operating expenses, including insurance coverage. He owns all the equipment or rents it, and he is responsible for all maintenance. The corporation provides none of the drivers. Conclusion: An IC.

3. *Computer Industry:*

The computer industry has been notorious for laying people off and then hiring them back purportedly as ICs. Again, only one example is given.

A computer programmer is laid off due to downsizing. He is hired back under a contract that will pay him a flat amount to complete a one-time project to develop a certain product, but it is not clear how long it will take to complete it. Accordingly, he is not guaranteed any minimum amount for the time he spends. He gets no instructions beyond the specifications for

the project. His contract categorizes him as an IC and that he is to receive no benefits from the corporation. The corporation issues the programmer a 1099-MISC. The programmer works on his own computer at his home and is not expected to attend corporate meetings. Conclusion: An IC.

This example is troubling. Quite often people laid off are hired back for a project, work on it full time, and then are assigned to another project and then another on a continuous full-time basis for an extended time period. The author of this article is familiar with a situation where a programmer worked exclusively for a company for about two years purportedly as an IC. It would seem that at a certain point, the person should be considered an employee even where the work is done at home, which is clearly feasible for computer programmers.

4. Automobile Industry:

- Example 1: This example involves the typical car salesperson. She works six days a week and is required to be in the showroom during times assigned by the dealership. She appraises trade-ins, subject to approval by a manager, develops leads and reports results to a manager. She is experienced and need minimal assistance in closing and financing sales. Her compensation is commission based and she is provided health insurance and group-term life insurance. Conclusion: An employee.
- Example 2: An individual is a mechanic at an auto dealership. He works regular hours and is paid on a percentage basis of the repair cost. He has no investment in the repair department. He is provided with the facilities, parts and supplies. He determines the amount to be charged for the repair, parts to be used

and the time to complete the job. He checks all estimates and repair orders. Conclusion: An employee.

- Example 3: In this case, a person does auto body repairs in space furnished by an auto dealership. He provides his own tools, equipment and supplies. He does all the bodywork coming into the dealership, but seeks out bodywork from insurance adjusters and others. He hires his own helpers, determines his own and his helpers hours, quotes prices for repair work, makes all adjustments and assumes all bad debts. His compensation is a large percentage of the gross collections from the body shop. Conclusion: An IC.

5. Taxicab Driver:

An individual rents a cab from a taxi company for a fixed amount per day. He pays the cost of maintaining and operating the cab and keeps all fares. He utilizes the cab company's two way radio communication equipment and dispatcher, and benefits from advertising by the taxi company. Conclusion: An IC.

6. Salesperson:

Apparently due to the myriad situations involving salespersons, no specific examples are given. Accordingly, each case stands alone and common-law principles must be applied in determining whether salespersons are employees.¹⁷

Even if a salesperson is not an employee under common-law principles, his or her pay may still be subject to social security, Medicare, and federal unemployment taxes. Such a salesperson is classified as a statutory

employee. A person is deemed to be a statutory employee if all eight elements of the statutory employee test are met:

1. Works full time for one person or company, except for sideline sales activities for others.
2. Turns over all sales orders to the company for which she or he works.
3. Sells to wholesalers, retailers, contractors, or operators of hotels, restaurants or similar establishments.
4. Sells merchandise for resale or use by the customer.
5. Does substantially all the above work personally.
6. Has no substantial investment in the facilities used to do the work, other than for a transportation facility, such as an automobile..
7. Maintains a continuing relationship with the person or company for which he or she works.
8. Is not an employee under common law rules.¹⁸

III. STATUTORY EMPLOYEES

For purposes of social security and Medicare provisions only, there are four categories of persons classified as statutory employees,¹⁹ and for two of the categories federal unemployment tax is applicable.²⁰ Thus, for a statutory employee, no withholding of income tax is required. The four categories of employees for whom social security and Medicare are applicable are those who perform services for remuneration as:

- An agent-driver or commission-driver engaged in distributing meat, vegetable, fruit or bakery products, beverages (other than milk), or laundry or dry cleaning services for a principal;
- A full time life insurance salesman;
- A home worker performing work, according to specifications furnished by the person for whom services are performed, on materials or goods furnished by such person, which are required to be returned to such person or someone designated by him;
- A traveling salesperson, other than as an agent-driver or commission-driver, engaged upon a full-time basis in the solicitation on behalf of, and the transmission to, his or her principal of orders from wholesalers, retailers, contractors, or operators of hotels, restaurants or similar establishments for merchandise for resale or supplies for use in their business.

With respect to all four categories, the contract of service must contemplate that substantially all of the services are to be performed personally by such individual. However, an individual will not be considered a statutory employee under these provisions if the person has a substantial investment in facilities used in connection with the performance of such services (other than transportation facilities), or if the services are in the nature of single transaction not part of a continuing relationship with the person for whom the services are performed.²¹

A person can be a statutory employee only if the person is not otherwise a common law employee. Statutory employees may deduct expenses in arriving at adjusted gross income and therefore are not subject to the 2% reduction applicable when employee expenses are itemized.²² The regulations under the

applicable code section go into considerable further detail concerning whether a person qualifies as a statutory employee.²³ Compensation paid to a statutory employee is subject to federal unemployment tax except for a life insurance salesman and a home worker.²⁴

IV. STATUTORY NON-EMPLOYEES

A person performing services as a qualified real estate agent or direct seller is not considered an employee and the business hiring such person is not considered an employer.²⁵

A person is a "qualified real estate agent" if the person is licensed, substantially all of his or her remuneration is based on sales, and the services are performed pursuant to a written contract providing that the person will not be treated as an employee for federal tax purposes.²⁶

A person is a "direct seller" if the person is engaged in the business of selling consumer products to a buyer on a buy-sell or deposit-commission basis, or any similar basis, for resale in the home or at a place of business other than in a permanent establishment, including someone engaged in the business of delivering or distribution of newspapers or shopping news. Here too, all of the remuneration must be based upon sales and the services must be provided pursuant to a written contract providing the person will not be considered an employee for federal tax purposes.²⁷

V. EFFECT OF MISCLASSIFICATION

Classifying a person as an IC when there is no reasonable basis for doing so results in the business being liable for employment taxes for the worker.²⁸ Additionally, the "responsible persons" within a business organization who fail

to collect, truthfully account for and pay over tax withheld to the government, in addition to any other penalties provided by law, are liable for a penalty equal to the total amount of tax not collected, or not accounted for and paid over.²⁹ This penalty is sometimes referred to as the 100% penalty. Moreover, it cannot be discharged in bankruptcy.³⁰

VI. RELIEF PROVISION

The classification of a person as an IC who properly should have been classified as an employee, can be very costly to a business, possibly resulting in its demise, the continuing liability of the owners of the business for withheld taxes and, as indicated, no relief possible under the bankruptcy laws.

In 1978, Congress enacted a relief provision as part of the Revenue Act of 1978, specifically Section 530 of the Act, to foster settlements in contentious cases, and perhaps to avoid the downfall of businesses assessed a large claim for taxes that should have been withheld, and consequent penalties.³¹

The relief provision provides that if a business never treated an individual as an employee, and for all periods after 1978 all federal tax returns that were required to be filed for the individual were filed as if the person were a non-employee, then the individual for that period will not be deemed to be an employee, unless there was no reasonable basis for treating the person as a non-employee. In essence, this means that the individual was never treated as an employee by the business and that the appropriate information returns (i.e., Form 1099-MISC) were consistently filed with the IRS for the individual. Relief is not allowed, however, if the Form 1099-MISC is filed after the IRS questioned the individual's status on an audit.³² If taxes were withheld for the individual, whether or not remitted to the IRS, such withholding would result in the person being

classified as an employee.³³ Furthermore, relief is possible only if the business treated individuals in similar positions consistently. After 1996, the IRS was required to give notice of the relief provision at the onset of any worker reclassification audit.³⁴

The key to obtaining relief, however, and a tough hurdle to leap, is the requirement that there be a reasonable basis for classification as an IC. Based on case law, one possibility is for the business to show that the misclassification as an IC was based upon the advice of an attorney.³⁵ Although the cases providing relief under Section 530 involved advice by an attorney, the IRS has stated that a reasonable basis would exist where the business relied upon the advice of an attorney or accountant who knew the facts about the business.³⁶

VII. REASONABLE BASIS SAFE HAVEN RULES

In a Revenue Procedure issued in 1985, the IRS set forth several safe haven alternative standards for determining whether a taxpayer has a reasonable basis for not treating an individual as an employee.³⁷ Reasonable reliance on any one of the safe havens is sufficient to uphold classification as an IC:

A. Precedent.

Judicial precedent or published rulings (whether or not related to the particular business of the taxpayer), technical advice or a determination letter pertaining to the taxpayer.

B. Prior Audit.

A past IRS audit (whether or not related to employment tax issues) where no assessment was made for treating persons as

ICs provided such persons held similar positions to the persons whose status is at issue.

C. Industry Practice.

Long-standing industry practice of a significant segment of the industry in which the individual whose status is at issue is engaged. The benchmark for a significant segment of the industry is 25%, but may be less depending on the facts and circumstances. A practice will be considered of long-standing if it has continued for at least ten years, but again may be less depending on the facts and circumstances.³⁸

A taxpayer who fails to meet any one of the three safe havens may nevertheless be entitled to relief if the taxpayer can demonstrate, in some reasonable manner, a reasonable basis for not treating the individual as an employee. According to a Congressional report, the term "reasonable basis" is to be construed liberally in favor of the taxpayer.³⁹ It is important to recognize that the safe haven provisions are applicable only if the business did not treat the individual whose status is at issue as an employee by withholding tax or otherwise filing employment tax returns with respect to the individual. Moreover, relief under Section 530 does not change in any way the status, liabilities, and rights of the worker whose status is at issue. The liability of the employer for employment taxes is terminated, but the worker is not converted from the status of employee to IC. Relief of an employer from liability under Section 530 also relieves any responsible person from personal liability.⁴⁰

Since in many, and perhaps most, cases there is no applicable precedent or prior audit, the only safe haven that is germane is the demonstration to the IRS of a long-standing industry practice of a significant segment of the industry. As a

practical matter, it would seem difficult for a business to prove a long-standing industry practice by making inquiries of other companies. Clearly, any company treating a worker as an IC and not an employee in a doubtful situation would be loathe to admit to such treatment or to provide any relevant information for fear of being audited itself by the IRS. Accordingly, the possibility of demonstrating an industry practice by obtaining information from companies similar to one's own would seem quite limited. However, although it is generally up to the taxpayer to prove what it is asserting, there is a chance that the IRS will investigate whether there is a long-standing industry practice. In one situation, the taxpayer submitted the names of twenty competitor firms in Manhattan that purportedly treated similarly situated workers as ICs. The IRS itself conducted a survey of the 20 firms in order to see if there was in fact a long-standing industry practice. Although the survey showed that there was no long-standing industry practice, the point is that it was the IRS that conducted the survey. Obviously, the businesses named had no choice but to respond to the IRS inquiries, whereas inquiries by the business being audited would probably have been disregarded.⁴¹

In summary, if a business has consistently treated an individual as an IC along with others in similar positions, although erroneously, the business will be relieved of liability for payroll taxes if there is a reasonable basis for treating that individual as a non-employee and Form 1099-MISC has been filed for the individual. And, as noted, any responsible person will escape personal liability.

VIII. CLASSIFICATION SETTLEMENT PROGRAM

Whether a worker should be classified as an IC or employee is a difficult issue for many businesses, as well as for the IRS. In fact, for many years, the IRS was prohibited from issuing any guidance regarding employment tax status. Businesses had long complained about the uncertain results of the worker classification standards, which essentially were a facts-and-circumstances test, as required by law.⁴² The uncertainty apparently was also of great concern to the IRS since it sometimes conceded the applicability of Section 530 in close cases, where there were mixed precedents, because of litigating hazards.⁴³

In an attempt to make it easier for businesses and the IRS to reach agreement when the worker classification issue is raised, the IRS initiated a Classification Settlement Program ("CSP") that established standard settlement agreements in worker classification cases, and allowed businesses and tax examiners to resolve worker classification cases as early as possible in the administrative process.⁴⁴

Under the CSP, IRS examiners can offer a business under audit a worker classification settlement agreement using a standard closing agreement. Generally, under such a closing agreement, a business that has filed Form 1099-MISC information returns for all similarly situated workers but failed to meet any other requirements for relief under Section 530 (i.e. failed to show a reasonable basis for the classification) could reclassify its workers prospectively and pay only a specified tax assessment not exceeding one year's liability. If applicable, the CSP offers a strong incentive to settle since the classification issue often involves more than one year. The exact amount of the assessment would depend on the extent to which the business satisfied the other requirements of Section

530 (i.e. reasonable basis requirement). Participation by a business in the CSP is strictly voluntary. A business declining to accept a settlement offer would retain all appeal rights.⁴⁵

Although the CSP is clearly beneficial to a business where a worker classification issue is on the fence, it also provides the IRS with another option. Prior to initiating the CSP, the IRS was often faced with the prospect of either conceding complete relief under Section 530 or litigating whether the section is applicable, with all the hazards and time and expense of litigation. The CSP gives the IRS another way to collect some tax in a disputed case, though limited to one year.⁴⁶

To summarize, if the business has been consistent in treating similarly situated workers as ICs and has filed Form 1099-MISC for each such worker, then Section 530 is applicable and an assessment for only one year is possible. Moreover, the assessment can be limited to 25% of the one-year assessment if the business can further present a colorable argument that it satisfies the reasonable basis test. Of course, if the taxpayer can show that it meets all three tests (i.e., employee consistency, reporting consistency and reasonable basis), complete relief under Section 530 is available. Accordingly, the 25% solution seems applicable where both the IRS and the taxpayer are uncertain as to whether there was a reasonable basis for the classification. For example, the taxpayer may show that some similar businesses treat workers as ICs but others do not. Or, perhaps the taxpayer alleges that it relied on the written advice of an attorney, but the advice turns out to be somewhat ambiguous. Thus, the 25% solution seems to be the final compromise obtainable from the IRS by a taxpayer where it is a close call as to whether there was a reasonable basis for the classification. It should be obvious, however, that the IRS will not settle for 25% of one year's liability unless it believed that its case was problematic.

If the business settles under the CSP and pays the one-year assessment, it will be entitled to a deduction for such payment since it effectively will constitute additional wages. Accordingly, the impact of the one year assessment is somewhat ameliorated. If the business is operating as an S Corporation, the benefit of the deduction will flow through to the shareholders. However, an IRS agent advised the author of this article that a condition of the 25% settlement would be no corresponding deduction.

IX. CONCLUSION

The issue of whether a worker is an employee or an IC is of particular concern when a business hires freelancers or consultants. In addition to significant tax exposure where there is a misclassification – possibly causing the demise of the business – there might be exposure to a costly lawsuit brought by the workers erroneously classified as ICs.

Microsoft faced just such a problem when it hired what it considered freelancers in addition to its regular employees. The freelancers received cash compensation but no fringe benefits. They were hired for a variety of specific projects and all signed agreements acknowledging that they were ICs. They did not participate in any employee benefit plans and Microsoft did not pay any federal employment taxes or withhold income tax for them.

The problem for Microsoft was that it did not treat these workers as ICs. Instead, the freelancers were integrated into the regular workforce often working on teams with full-time employees and performing the same functions. They had to work on site and received all of their equipment and supplies from Microsoft. This treatment got Microsoft in trouble with

the IRS back in 1989 and 1990. Ultimately, Microsoft agreed with the IRS to treat the workers as employees for purposes of tax withholding and any other federal tax obligations paying all back taxes owed.

This, however, was not the end of the story. The affected workers demanded full employee benefits for the time they were classified as ICs. This included, among other things, coverage in the company's 401(k) plan and a discount stock purchase plan, both of immense value. When Microsoft refused, the workers file suit in federal court. Although the district court dismissed the suit, on appeal the Ninth Circuit held for the workers.⁴⁷ Subsequently, a 15-judge panel of the Ninth Circuit reheard the case. Their decision largely affirmed the prior decision of the appellate court.⁴⁸

A lesson to be gleaned from the Microsoft case is that simply having a worker sign an agreement that he or she is an IC is not determinative of the worker's status. The determination as to status will be based on the law not self-serving documents. The tax penalties for misclassification are severe although possibly now ameliorated by the CSP. Perhaps of equal if not more important consideration is that a misclassification will be even more expensive if the business has generous fringe benefits such as Microsoft. Whether contingent workers can be excluded from fringe benefit plans is problematical.

Firms and workers can request a determination of status by filing Form SS-8 ("Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding"). This is a quite lengthy form that asks for a lot of information and asks numerous questions. It is noteworthy that a worker can file the form. Accordingly, a worker who feels that he or she is really an employee and not an

independent contractor can complain to the IRS by filing the form. If the worker is truly disgruntled, he or she can also complain to the state unemployment and worker's compensation agencies. Of course, this may result in loss of employment unless the worker has already been let go or has left.

No doubt there are many in business that knowingly misclassify workers in order to save money taking a chance that they can get away with it. One should think twice, however, since, as this paper explains, the consequences if caught can be disastrous.

ENDNOTES

¹ Any person engaged in a trade or business for whom services are provided by a non-employee is required to provide a statement to the service provider, with a copy filed with the IRS if, in connection with its trade or business, it pays an amount to such person totaling \$600 or more within the taxable year, specifically, Form 1099-MISC, Miscellaneous Income (IRC §6041A). There is a whole series of Forms 1099 covering various types of payments (e.g., interest: Form 1099-INT; dividends: Form 1099-DIV; and, pension payments: Form 1099-R.) I.R.C., §6041, Reg. §1.6041, I.R.C. §6042.

² I.R.C. §3121(d)(2).

³ I.R.C. §3121(d)(1).

⁴ Reg. §31.3121(d)-1(c)(2).

⁵ *Id.* The common law rules for determining whether an employer-employee relationship exists are contained pretty much word-for-word in the regulations relating to social security and Medicare taxes (Reg. §31.3121(d)-1(c)), the regulations relating to federal unemployment tax (Reg. §31.3306(i)-1(b)), and the regulations relating to withholding of income tax (Reg. §31.3401(c)-1(b)).

⁶ *Id.*

⁷ Reg. §31.3121(d)-1(c)(3).

⁸ Reg. §31.3401(c)-1(e).

⁹ Reg. §31.3401(c)-1(f).

¹⁰ Rev. Rul. 69-184, 1969-1 C.B. 256.

¹¹ In Rev. Rul. 87-41, 1987-1, C.B. 296, the IRS set forth the 20 factors to consider in determining whether someone is an employee or IC. Many of the factors are incorporated in the revised analysis.

¹² IRS Training Manual 3320-102 (October 1966), IRS Publication 15A.

¹³ IRS Publication 15A.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ I.R.C. §3121(d)(3).

²⁰ I.R.C. §3306(i).

²¹ I.R.C. §3121(d)(3).

²² Rev. Rul. 90-93, 1990-2 C.B. 33.

²³ *See* Reg. §31.3121(d)-1(d).

²⁴ I.R.C. §3306(i).

²⁵ I.R.C. §3508.

²⁶ I.R.C. §3508(b)(1).

²⁷ I.R.C. §3508(b)(2).

²⁸ I.R.C. §3509.

²⁹ I.R.C. §6672. There is a substantial body of case law dealing with whether a person is a "responsible person," the result depending upon the particular facts and circumstances.

³⁰ 11 U.S.C. 507(a)(8)(C).

³¹ Section 530 of the Revenue Act of 1978. This provision was not codified as part of the Internal Revenue Code.

³² Rev. Rul. 81-224, 1981-2 C.B. 197.

³³ Rev. Proc. 85-18, 1985-1 C.B. 518, Section 3.03.

³⁴ The Small Business Job Protection Act of 1996, Pub. L. 104-188, Section 1122.

³⁵ *Select Rehab, Inc. v. United States*, 205 F. Supp. 2d 376 (M.D. Pa. 2002); *North Louisiana Rehabilitation Center, Inc. v. United States*, 179 F. Supp. 2d 658 (W.D. La. 2001).

³⁶ Publication 1976 (9-96).

³⁷ Rev. Proc. 85-18, 1985-1 C.B. 518.

³⁸ The Small Business Job Protection Act of 1996, Pub. L. 104-188, Section 1122.

³⁹ H.R. Rep. No. 95-1748, 95th Cong., 2d Sess. 5 (1978), 1978-3 (Vol. 1) C.B. 629, 633.

⁴⁰ Rev. Proc. 85-18, 1985-1 C.B. 518, Section 3.07.

⁴¹ *See* 1997 Field Service Advice (FSA) LEXIS 492.

⁴² I.R.C. §3121(d)(2).

⁴³ *See* 1998 FSA LEXIS 375.

⁴⁴ 1996 IRB LEXIS 76; IR 96-7. The IRS implemented the CSP on a two-year trial basis in 1996. Review of the program and feedback from the public indicated that the program was successful in facilitating early resolution of cases. Accordingly, the IRS extended the CSP indefinitely (Notice 98-21; 1998 IRB LEXIS 152).

⁴⁵ The CSP establishes administrative appeal rights even while an examination of other issues is in progress. For appeal rights to the United States Tax Court, *see* I.R.C. §7436 and Notice 2002-5, 2002 IRB LEXIS 25.

⁴⁶ *See* 1997 FSA LEXIS 492.

⁴⁷ *Vizcaino v. Microsoft Corp.*, 97 F.3d 1187 (9th Cir. 1996).

⁴⁸ *Vizcaino v. Microsoft Corp.*, 120 F.3d 1006 (9th Cir. 1997).